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PUBLIC UTILITIES COMMISSION

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF HAWAII

----In the Matter of ----	)	
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PUBLIC UTILITIES COMMISSION	)	DOCKET NO. 05-0002
	)	
Instituting a Proceeding to Investigate the Issues and Requirements Raised by, and Contained in, Hawaii Revised Statutes 486H, as Amended.	)))))	

TESORO HAWAII CORPORATION'S STATEMENT REGARDING "RECOMMENDATIONS TO MODIFY HAWAII REVISED STATUTES CHAPTER 486H, GASOLINE PRICE CAP LEGISLATION, FOR THE ETHANOL MANDATE, HAWAII ADMINISTRATIVE RULES, TITLE 15, CHAPTER 35, SUPPLEMENT 1," SUBMITTED BY ICF CONSULTING, LLC

AND

CERTIFICATE OF SERVICE

CRAIG I. NAKANISHI
SHAH J. BENTO
Rush Moore, LLP
737 Bishop Street, Suite 2400
Honolulu, Hawaii 96813
Telephone: (808) 521-0400

Attorneys for
TESORO HAWAII CORPORATION

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TESORO HAWAII CORPORATION'S STATEMENT

I. Introduction

On March 23, 2006, ICF Consulting, LLC ("ICF") submitted "Recommendations to Modify Hawaii Revised Statutes Chapter 486H, Gasoline Price Cap Legislation, for the Ethanol Mandate, Hawaii Administrative Rules, Title 15, Chapter 35" ("Original Recommendations") to the Public Utilities Commission of the State of Hawaii ("Commission"). On April 13, 2006, ICF supplemented its Original Recommendations[1] explaining:

> At the request of the...Commission..., ICF was asked to comment in two additional areas:
>
> 1. Suggest an alternative process to assess the competitive delivered price for ethanol into Hawaii for blending E-10 gasoline. The process recommended by ICF in our March 23, 2006 report depended on direct utilization of actual delivered cargo prices and resales into Hawaii. The PUC has indicated that this process may not be a feasible method because it may result in the disclosure of confidential information consisting of actual ethanol purchase information that all Parties submitting confidential information would not consent to.

[1] "Recommendations to Modify Hawaii Revised Statutes Chapter 486H, Gasoline Price Cap Legislation, for the Ethanol Mandate, Hawaii Administrative Rules, Title 15, Chapter 35 Supplement 1" (Apr. 13, 200[6] (date in the original of April 13, 2005 appears to be an inadvertent misprint) (hereinafter referred to as "Supplement").

> 2. Comment on the possible use of the OPIS Conventional gasoline prices as a baseline for the HIBOB market price given the relative tradeoff between the cost of the required reduction in vapor pressure to manufacture HIBOB gasoline blendstock, and the benefit of lower octane requirements to manufacture the HIBOB blendstock.

By request on April 13, 2006, the Commission asked Tesoro Hawaii Corporation ("Tesoro Hawaii") and the parties to this docket to provide comments on ICF's Supplement by the close of business on April 19, 2006. Accordingly, Tesoro Hawaii respectfully submits the following comments for the Commission's consideration.

II. Tesoro Hawaii's Position

ICF's Original Recommendations recognize that there are three major cost categories that the oil industry will incur in providing E-10 gasoline to Hawaii:

1) Costs to acquire and import ethanol;
2) Cost to produce the HIBOB grade of gasoline for ethanol blending; and
3) Costs incurred in the distribution and storage of ethanol (capital modifications, barging costs, operational costs, and higher inventory levels).[2]

Tesoro Hawaii addresses each of these major cost categories below.

1. Costs to acquire and import ethanol

By written statement filed with the Commission on April 5, 2006, Tesoro Hawaii did not object to the ethanol pool price approach proposed by ICF in its Original Recommendations. The Company also did not disagree that the Commission may publish the industry aggregated ethanol pool price as part of the Commission's active implementation, supervision, and compliance with Hawaii's ethanol and gasoline wholesale price cap laws. It is Tesoro Hawaii's position that the best sources to determine costs are the local companies who must bear them. Tesoro Hawaii believes that these costs ultimately produce fairer wholesale gasoline prices that reflect and

[2] *See* ICF's Original Recommendations at 35.

correlate with competitive market conditions.[3] Given the apparent procedural unworkability posed by ICF's Original Recommendations, Tesoro Hawaii believes that swift relief in the form of some recognition of ethanol costs, however imperfect it may be, is preferable to no relief at all. However, it should be noted that aligning the transportation/location adjustment on the ethanol with the transportation/location adjustment currently used for the conventional gasoline pricing analysis is erroneous. Ethanol is generally transported in smaller, specialized vessels with a correspondingly higher transportation cost than for regular gasoline and other commodity fuels. At this time, Tesoro Hawaii does not object to either (1) the ethanol pool price approach proposed by ICF in its Original Recommendations or (2) the imposition of the recovery methodology set forth in ICF's Supplement for determining ethanol costs but recommends the methodology be reevaluated after a reasonable interval to be determined by the Commission.

In Hawaii, refiners relied upon statements by the local ethanol industry in sizing facilities to accommodate local inventories. The failure of the local ethanol industry to deliver has resulted in high costs in a tight ethanol market and strained storage and terminal facilities. In short, it is not possible for Tesoro Hawaii to achieve full import economies of scale because it is disadvantaged on ethanol costs having prepared for the advent of local ethanol supply. Comparison to mainland ethanol markets such as Los Angeles overlooks the lack of comparable scale ethanol import facilities in Hawaii and the inability to source large ethanol cargoes with advantaged marine freight economics. The refiners and others in Hawaii are limited to importing ethanol in smaller marine cargoes which carry higher marine freight costs on a per gallon basis.

2. Costs to produce HIBOB

ICF's Original Recommendations recognized that there should be a 4 cpg (a net 3.6 cpg as a 90 percent component) upward adjustment to the baseline HIBOB price **to reflect the**

[3] Haw. Rev. Stat. § 486H-13(b) (2005).

higher cost for Hawaii refiners to produce the gasoline blendstock (HIBOB) for ethanol blending.[4] Tesoro Hawaii agrees with the intent of ICF's statement. ICF's original proposed adjustment was to be a fixed premium to the current conventional gasoline baseline price.

The production adjustment is notably absent from ICF's Supplement. Although ICF does not explicitly explain why it removed the adjustment, Tesoro Hawaii reasonably concludes that it could not be due to any disagreement among the parties over confidentiality of the ethanol pool price in ICF's Original Recommendations. ICF asserts in its Supplement--reversing its earlier position: "Generally speaking, the cost to produce a conventional BOB product such as HIBOB is likely **lower** than the cost of producing conventional gasoline."[5]

The factors mentioned by ICF in reaching this conclusion are unsupported by any credible documentation. Moreover, the factors are irrelevant. ICF appears to argue that because an <u>importer</u> of BOB would not need a production cost adjustment, refiners are not entitled to one. ICF ignores reality when it attributes a cost savings to refiners for octane reduction when Hawaii's market is limited to existing gasoline demand. Tesoro Hawaii respectfully submits that ICF's reasoning does not form a credible basis supported by substantial material considerations for the Commission. Accordingly, the Commission should not abandon the production adjustment of 4 cpg ICF arrived at so carefully using the input of the parties in its Original Recommendations.

The first point ICF makes in the Supplement is that HIBOB is not RBOB. This states the obvious but there is no cost support to assist the Commission to conclude just what those differences are. These differences are, of course, not in any way related to costs for Hawaii refiners to produce a gasoline blendstock for ethanol blending.

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[4] ICF's Original Recommendation at 4 (emphasis added).
[5] ICF Supplement at 3 (emphasis added).

Simply put, with its focus on equating HIBOB and conventional product, the Supplement completely ignores the actual refining process in Hawaii. This is not something about which ICF is unaware. ICF expressly caveats that its approach has been based on a premise that Hawaii refiner costs are "less significant" than determining costs of alternative BOB supply options.[6]

As well, ICF fully understands these questionable relationships because it cautiously prefaces its remarks to the Commission. ICF advises that Hawaii refiners have gasoline blending limitations (such as distillation) which require additional blendstock changes to ensure that gasoline meets all drivability and performance standards after ethanol is added. Additionally, ICF observes that Hawaii refiners have issues and costs related to the need to export naphtha or gasoline to re-balance supply and demand as a result of the Ethanol Mandate.[7] In short, the methodology for determining costs is controlling over the costs themselves.

In ICF's Original Recommendations, it states: "The cost to produce HIBOB is likely higher than the mainland "BOB" market differential based on information provide by the Parties and ICF Analysis."[8] "The responses from the refiners indicated that the cost to produce HIBOB and lower gasoline production in Hawaii is higher than the average market price differentials on the mainland for RBOB and CARBOB."[9] "ICF believes that sufficient evidence exists of the higher costs to produce HIBOB gasoline to support the development of a HIBOB cost to utilize in lieu of depending on the volatile mainland spreads…."[10] The point here is not to take issue with the methodology proposed in the ICF Supplement, but more to show that there is ample

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[6] Supplement at 4.
[7] Haw. Rev. Stat. § 486J-10 (2005); Haw. Admin. R. § 15-35-2 (2004) (hereinafter referred to as the "Ethanol Mandate"); ICF's Supplement at 3.
[8] Original Recommendations at 12.
[9] *Id.* at 13.
[10] *Id.* at 14.

justification to support a 4 cpg production adjustment **to reflect the higher cost** for Hawaii refiners to produce the gasoline blendstock (HIBOB) for ethanol blending.[11]

The second point ICF makes in its Supplement is that lower octane and lower vapor pressure "tend" to offset each other. Tesoro Hawaii is uncertain what precisely this statement is meant to support. That being the "tendency" (ignoring such critical costs specific to Hawaii refiners as distillation specifications and naphtha export costs) ICF concludes that it costs more to produce conventional gasoline than HIBOB. This unsupported statement, which was not a consideration in ICF's Original Recommendations, should not be used as the basis for the Commission's decision.

Against this backdrop, ICF rightfully cautions that the "economics of each of these offsets can vary widely based on prevailing markets."[12] Moreover, Tesoro Hawaii notes that octane is not a product, and is neither fungible nor marketable. Assigning a particular cpg number to each octane point, without understanding or considering the costs underlying that octane level is, at best, inconsistent with refinery methods and costs. A meaningful relation to a Reid Vapor Pressure ("RVP") reduction for butane, even assuming (which is a large question in and of itself) that one can accurately project butane price levels is very problematic.

Finally, as noted in Tesoro Hawaii's initial response to Order No. 22056, with the Commission on November 1, 2005 ("Initial Response"), the impact of the Ethanol Mandate on the local refining infrastructure is likely to be more severe here than elsewhere in the United States. Tesoro Hawaii's refinery will be adversely affected by both the cost to produce a low RVP ethanol BOB, and the resulting disposal of the displaced light naphtha component (as well as other components) of the gasoline at reduced margins. Moreover, there is no benefit to Tesoro

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[11] *Id.* at 4

[12] ICF's Supplement at 3.

Hawaii from the low sulfur content of the ethanol since the gasoline manufacturing process at Tesoro Hawaii's refinery already produces an ultra-low sulfur gasoline product. In addition, the effect of introducing 10 percent ethanol blending into the gasoline pool may adversely impair the utilization of its manufacturing assets. All of these tangible and intangible costs are an inherent and important part of the many factors and issues that the Commission should be trying to address. Nowhere are these costs adequately addressed by the ICF Supplement.

Again, even if one were to accept the conclusions reached by ICF, Tesoro Hawaii does not believe they correlate with or reflect competitive costs. The data, and information submitted by the parties which resulted in a 4 cpg HIBOB production adjustment to reflect the higher cost for Hawaii refiners to produce the gasoline blendstock for ethanol blending is a far more reasonable basis. Tesoro Hawaii respectfully submits that, while it does not necessarily agree with all of ICF's Original Recommendations, ICF "got it right" with regard to the need for an adjustment to the current baseline price for gasoline to reflect higher costs to Hawaii refiners as a result of the Ethanol Mandate.

3. Zone Adjustments for E-10 Gasoline

With respect to the third cost category, costs incurred in the distribution and storage of ethanol, Tesoro Hawaii believes that by focusing solely upon the questions that the Commission asked, ICF did not intend to withdraw its recommendations for the Summary Zone Adjustments for E-10 Gasoline, set forth at page 34 of ICF's Original Recommendations. These adjustments are not at issue here and are not challenged by ICF's Supplement. The adjustments for E-10 Gasoline recognize the additional terminal, barge, trucking , inventory and other operational costs so critical to the ability of refiners to comply with the Ethanol Mandate. Tesoro Hawaii strongly supports acceptance of ICF's Original Recommendation with respect to the Summary

Zone Adjustment for E-10 Gasoline in order to recognize legitimate costs incurred in complying with Hawaii's Ethanol Mandate for the reasons set forth in Tesoro Hawaii's Initial Response at pages 19-20.

III. Conclusion

ICF concludes its Supplement stating: "As noted, ICF did not recommend this [Supplement] approach, and are providing comments related to the logic of this assessment under the premise that the Hawaii refiner costs to produce HIBOB are a less significant factor to the Commission than determining the cost of possible alternative competitive supply options for a BOB product."[13] Tesoro Hawaii understands that the direct utilization of actual delivered cargo prices and resales into Hawaii was ICF's preferred approach in its Original Recommendations. Tesoro Hawaii's supported ICF's preferred approach because the Company believes that these costs ultimately produce fairer wholesale gasoline prices than the use of proxy markets. However, without expeditious adjustment using the methodology recommended in ICF's Supplement, the Company will continue to bear the Ethanol Mandate's increased costs without any recovery. Wholesale E-10 prices that provide for **no** recovery for the increased costs of ethanol blending "do not reflect and correlate with competitive market conditions."[14] This is not the intent of Hawaii's petroleum laws and the Commission's careful measured implementation which has sought to balance refiner viability and consumer interests.

Tesoro Hawaii appreciates the level of effort invested by the Commission during these deliberations. However, as the Commission knows, ethanol blending began in Hawaii approximately March 15 in order to be in compliance with the provisions of the Ethanol Mandate which required 85% of the gasoline supply in Hawaii to contain at least ten percent ethanol by

[13] ICF Supplement at 4 (emphasis added).
[14] Haw. Rev. Stat. § 486H-13(b) (2005).

April 2, 2006. For approximately one month since March 15, Tesoro Hawaii has incurred significant costs to comply with the provisions of the Ethanol Mandate without any economic relief through the adjustment of the gasoline price cap mechanism. This is of great concern to the Company and Tesoro Hawaii appreciates all efforts by the Commission to provide resolution on the ethanol adjustment.

DATED: Honolulu, Hawaii, April 19, 2006.

By: Shah J. Bento

Craig I. Nakanishi
Shah J. Bento

Attorneys for
TESORO HAWAII CORPORATION

CERTIFICATE OF SERVICE

I hereby certify that I have this date served copies of the foregoing upon the following parties by mail, postage prepaid and properly addressed.

Department of Commerce and Consumer Affairs (2 copies)
Division of Consumer Advocacy
P.O. Box 541
Honolulu, HI 96809

Michael H. Lau, Esq. (1 copy)
Kent D. Morihara, Esq.
Morihara Lau & Fong, LLP
841 Bishop Street, Suite 400
Honolulu, HI 96813

Clifford K. Higa, Esq. (1 copy)
Bruce Nakamura, Esq.
Kobayashi, Sugita & Goda
First Hawaiian Center
999 Bishop Street, Suite 2600
Honolulu, HI 96813

Danny Batchelor (1 copy)
Senior Counsel
Shell Oil Company
P.O. Box 2463
Houston, TX 77252-2463

Kelly G. Laporte, Esq. (1 copy)
Marc E. Rousseau, Esq.
Cades Schutte, LLP
1000 Bishop Street, Suite 1200
Honolulu, HI 96813

Dated: April 19, 2006.

Sue Iwashita

Sue Iwashita